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Real Estate & Title Insurance

New Life for Bankrupt Projects?

Chapter 11 reorganizations may now be feasible for single asset real estate entities

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In the 1990s, the *Jason Realty* case dealt a near-death blow to Chapter 11 reorganizations of real estate entities in New Jersey. *In re Jason Realty, L.P.,* 69 F.3d 423 (3rd Cir. 1995). In *Jason Realty*, the Federal appellate court held that if the rents of a project are properly assigned by a landlord to a mortgage lender before the landlord's bankruptcy, then the rents are not the property of the landlord's bankruptcy estate and are not available to pay operating expenses of the project or fund a plan of reorganization of the landlord.

The court based its holding on both Federal law and New Jersey law. Under Federal law as articulated in the *Butner* case, bankruptcy courts are required to look to state property law for a determination as to whether the debtor has an interest in property. *Butner v. The United States*, 440 U.S. 48 (1979). Accordingly, the *Jason Realty* court looked to New Jersey law to determine the effect of the assignment of leases and rents that the debtor had signed in favor of the mortgage lender at the mortgage loan closing.

The court held that, under New Jersey law, the assignment of leases and rents was effective to vest in the mortgage lender title to the rents. While the debtor could continue to collect the rents after the loan closing, the debtor's right to do so was a mere license, and the license was automatically revoked upon the occurrence of a loan default. New Jersey courts have long held that a properly drafted assignment of leases and rents is effective as an absolute assignment of title to the rents, and not merely (as is the case in most other states) a pledge of the rents as collateral.

Accordingly, held the court, when the debtor in *Jason Realty* filed its Chapter 11 petition after a loan default, the debtor no longer had any property interest in the rents generated by its project. Without the rents, the debtor was unable to operate or fund a plan of reorganization. The court therefore granted the mortgage lender relief from the automatic stay, so as to allow the lender to proceed with its mortgage foreclosure.

Have the 2005 Bankruptcy Code amendments changed that result? Will Chapter 11 reorganizations now be feasible for real estate entities in New Jersey? The answer to these questions is unclear.

The 2005 act amended the single asset real estate provisions of the Bankruptcy Code in several material respects. First, the $4 million secured debt limit set forth in the definition of "single asset real estate" has been eliminated. Accordingly, the single asset real estate provisions apply to any debtor whose property qualifies as "single asset real estate," which is defined as:

> [A] single property or project which generates substantially all of the gross income of a debtor…and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental thereto. Section 101 (51B) of the Federal Bankruptcy Code.

Second, the debtor's right to prevent the lifting of the automatic stay by

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making monthly payments now requires such payments to be "in an amount equal to interest at the nondefault contract rate of interest" under the applicable credit agreement. Prior to the 2005 act, the debtor could pay interest at a current fair market interest rate, thereby creating a risk to the secured creditor that the bankruptcy court could determine the "fair market rate" to be lower than the contract rate.

Third, and possibly most important, the debtor now has the right to use rents from the property to make the monthly payments. The 2005 act amended Section 362(d)(3) of the Bankruptcy Code to provide that the monthly payments "may, in the debtor's sole discretion, notwithstanding Section 363(c)(2), be made from rents or other income generated before, on or after the commencement of the case by or from the property."

Does this last amendment allow the debtor to use the rents to make the monthly payments even where, as is the case in New Jersey under the *Jason Realty* doctrine, the debtor does not have title to the rents?

Arguably, that change in Section 362(d)(3) does not apply where the debtor does not have title to the rents. How (the argument goes) could the Bankruptcy Code allow the debtor to use property that the debtor does not own in order to avoid the granting of relief from the automatic stay? Instead (the argument continues) the change in Section 362(d)(3) applies only where the rents have been pledged to the mortgage lender, with title to the rents remaining in the debtor. Where the rents have been pledged, they constitute "cash collateral" of the mortgage lender, and Section 363(c)(2) of the Bankruptcy Code restricts the use by the debtor of cash collateral without the consent of the mortgage lender or, in the absence of consent, bankruptcy court approval. The change in Section 362(d)(3) certainly negates the requirement in Section 363(c)(2) of the mortgage lender's consent to the debtor's use of the rents, where the rents are cash collateral — but that change ought not apply at all where the debtor has no ownership interest in the rents.

On the other hand (the counter-argument goes), the change in Section 362(d)(3) is plain on its face: rents are permitted to be used by the debtor to make the monthly payments without bankruptcy court approval or notice to the mortgage lender. The statutory change does not expressly require that rents be property of the estate, in order for them to be used by the debtor for the monthly payments. The rents may be used to make the contemplated monthly payments even as to a junior mortgage, as well as the first mortgage.

If the counter-argument prevails, two issues remain:

First, does the change to Section 362(d)(3) overrule the legal principle that state law (not Federal bankruptcy law) determines whether a debtor has an interest in property, as held in the *Butner* decision of the U.S. Supreme Court? More specifically, are rents now to be considered property of the bankruptcy estate notwithstanding New Jersey law?

Second, if the debtor is allowed to use the rents that it may not own to make the monthly payments contemplated by Section 362(d)(3) during the pendency of the bankruptcy proceeding, is the debtor also authorized to use the rents it may not own in order to operate the property and fund a reorganization plan? By its terms, the change in Section 362 (d)(3) speaks only to the use of the rents towards the monthly payments required to stave off a motion by a lender for relief from the automatic stay; the change does not expressly authorize the use of the rents to pay operating expenses or fund a plan. Would the reorganization plan itself, as to New Jersey single asset real estate, still be incapable of being approved because of the reasoning of *Jason Realty*?

While the media has focused primarily on the impact of the 2005 act on consumer bankruptcies, a number of important provisions of the 2005 act impact Chapter 11 business cases, including single asset real estate bankruptcies. The impact of the 2005 act on established state law such as *Jason Realty* remains to be decided by the courts. ■